DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 02-0238
Gross Income Tax
For the Years 1995-1998

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ISSUE

I. Gross Income Tax-Imposition

640, (Ind. Tax 1992 **Authority:** IC 6-8.1-5-1(b), IC 6-2.1-2-2, IC 6-2.1-1-9, 45 IAC 1.1-6-2, First
National Leasing and Financial Corp. v. Indiana Department of Revenue, 598
N.E.2d).

The taxpayer protests the imposition of gross income tax on income from certain leases.

II. Tax Administration- Ten Per Cent (10%) Negligence Penalty

Authority: IC 6-8.1-10-2.1, 45 IAC 15-11-2 (b).

The taxpayer protests the imposition of the ten percent (10%) negligence penalty.

STATEMENT OF FACTS

During the audit period the taxpayer filed a financial institutions tax return with two of its affiliates who were engaged with the taxpayer in making loans and extending credit to businesses. Upon examination of the taxpayer's records, it was learned that the taxpayer did not meet the qualifications to be a financial institution under the financial institutions tax law. Therefore, the Indiana Department of Revenue, hereinafter referred to as the "department," performed a corporate income tax audit on the taxpayer. As a result of the audit, the department assessed gross income tax on the taxpayer's receipts from the leasing of aircraft, railcars, and manufacturing equipment located in Indiana. The department also assessed penalty and interest. The taxpayer protested the gross income tax and penalty assessments and a hearing was held. This Letter of Findings results.

I. Gross Income Tax-Imposition

DISCUSSION

All tax assessments are presumed to be accurate and taxpayers bear the burden of proving that any assessment is incorrect. IC 6-8.1-5-1(b).

Indiana imposes a gross income tax on the "taxable gross income derived from activities or businesses or any other sources within Indiana" of a nonresident taxpayer. IC 6-2.1-2-2. The department assessed gross income tax on the taxpayer's income from leases of aircraft, railcars, and machinery in Indiana. The taxpayer contended that its lease income was not derived from an Indiana source and therefore not subject to the Indiana gross income tax. The issue to be determined in this case is whether the taxpayer's lease income was actually derived from an Indiana source and was therefore subject to the Indiana gross income tax.

The gross income tax law concerning the taxability of income from intangibles such as the taxpayer's leases is clarified at 45 IAC 1.1-6-2 as follows:

> (b) Except as provided in subsection (c), receipts derived from an intangible are included in gross income.
> (c) Receipts derived from an intangible are not included in gross income under the following situations:
> (1) The intangible forms an integral part of:
> (A) a trade or business situated and regularly carried on at a business situs outside Indiana; or
> (B) activities incident to such trade or business.
> (2) The intangible does not form an integral part of a trade or business situated and regularly carried on at a business situs in Indiana, and the taxpayer's commercial domicile is located outside of Indiana.
> (3) The receipts from the intangible are otherwise excluded from gross income under IC 6-2.1-1-2 or 45 IAC 1.1-3-3(c)(7).
> (d) In determining whether an intangible forms an integral part of a trade or business or activities incident thereto under subsection (c) it is the connection of the intangible itself to such trade or business or activities incident thereto that is the controlling factor. The physical location of the evidence of the intangible (share of stock, bond, etc.) is not a controlling factor. Also, any activities related to the sale of an intangible occur after the fact and are never determinative.
> (e) As used in this section, "commercial domicile" means the nerve center of the taxpayer where a majority of the activities and functions of the business are performed. The department will include the following types of activities in making a determination of commercial domicile.
> (1) The location of management and administrative activities connected with each location, such as policy and investment decisions.
> (2) The location of meetings of the board of directors.
> (3) The residence of executives and their offices.
> (4) The location of books and records.
> (5) The location of payment on income from intangibles of the taxpayer.
> (6) The information from annual and quarterly reports of the taxpayer.

The Indiana Tax Court also dealt with the issue of the gross income taxability of a nonresident taxpayer's receipts from leases in First National Leasing and Financial Corp. v. Indiana Department of Revenue, 598 N.E.2d 640, (Ind. Tax 1992). In that case, First National leased equipment to another corporation which used the equipment in its train derailment business. The Court set out a three part inquiry for analyzing whether or not gross income from an intangible is subject to Indiana gross income tax. First the income must be gross income. Secondly the gross income must be derived from sources within Indiana. Finally the gross income that is derived from sources within Indiana must be subject to the Indiana gross income tax. In the first step of the analysis, the Court determined that First National actually received gross income from the leases of property used in Indiana. The Court next analyzed whether the gross income was derived from activities in Indiana. The leased equipment included several mobile items such as big over-the-road trucks, tractors, lowboy trailers, pick-up trucks, cranes, miscellaneous generators, light plants, and caterpillar tractors with side booms for lifting. That equipment was stored and used a portion of the time in Indiana. First National does not have control over the equipment nor does it know where the equipment is actually located at any particular time. All commercial activities such as negotiations and signing of documents related to the lease agreements took place outside Indiana. The Court determined that the First National's lease income derived from sources outside of Indiana. Therefore the income was not subject to the Indiana gross income tax.

The taxpayer's offices, administrative personnel, administrative services, board of directors, and books and records were all outside of Indiana. The taxpayer's lease income derives from leases that were negotiated, executed, and maintained outside of Indiana.

The taxpayer contends that its lease income was identical to the non taxable income of First National. As regards the airplanes and rail cars, the taxpayer's argument is persuasive. The gross income received from the leases of airplanes and rail cars is not derived from Indiana activities.

The taxpayer's argument is not persuasive as to the income from the lease of the manufacturing equipment. This is distinguishable from the leases of rail cars, airplanes, and mobile car derailment equipment where the taxpayers had no control over the location of the leased items. In those transactions, the taxpayers would have received their lease payments whether or not the leased items ever went through Indiana. As to the manufacturing machinery, there would be no lease income if the taxpayer had not agreed to lease the machinery to be used at the factory in Indiana. That makes the location and use of the heavy machinery at the Indiana factory an essential and integral part of the transaction as contemplated in the previously cited 45 IAC 1.1-6-2(c). The gross income from the lease of manufacturing machinery is derived from Indiana activities.

Finally it is necessary to determine if the gross income is taxable. The taxpayer contended that the taxpayer's income from the machinery lease must be computed following special rules because it qualified as a "qualified lessor" pursuant to IC 6-2.1-1-9(2) as follows:

> "Qualified lessor" means a taxpayer that:
>
> (A) acquires title to tangible personal property solely for the purpose of leasing it to others;
> (B) has no other purpose of ownership in the property; and

> (C) leases the property to another under a lease agreement which has a term of at least five (5) years and which requires the lessee to make rental payments, over the term of the lease, equal to the sum of: (i) the cost of the property, plus (ii) finance charges.

The provisions of the sample lease indicate that the taxpayer did meet the requirements to be considered a "qualified lessor." Therefore the taxpayer's gross income tax liability must be computed by reducing its total rental receipts by the "cost of the tangible property so leased" pursuant to IC 6-2.1-1-9(b).

FINDING

The taxpayer's protest to the gross income tax assessed on the income received from leases of airplanes and rail cars is sustained. The taxpayer's protest to the gross income tax assessed on the income received from leases of manufacturing machinery is to be recomputed pursuant to the provisions of IC 6-2.1-1-9(b).

II. Tax Administration- Ten Percent (10%) Negligence Penalty

DISCUSSION

The taxpayer protests the imposition of the ten percent (10%) negligence penalty pursuant to IC 6-8.1-10-2.1. Indiana Regulation 45 IAC 15-11-2 (b) clarifies the standard for the imposition of the negligence penalty as follows:

> Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to reach and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

When the taxpayer and the affiliated corporations reorganized due to changes in economic conditions, they had a duty to reanalyze their tax filing status and modify it to fit the new situation. The taxpayer's inattention to this duty constituted negligence.

FINDING

The taxpayer's protest is denied.

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